taxnotes® international

Volume 105, Number 4 ■ January 24, 2022

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Reprinted from *Tax Notes International*, January 24, 2022, p. 429

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In this article, Shah and McLaren review the mechanics of California's taxation of nonresidents regarding equity-based compensation and analyze the case of Elon Musk exercising over 21 million Tesla shares, in light of his departure from California at the end of 2020.

Given the recent news of Elon Musk exercising over 21 million Tesla shares, worth roughly $22 billion,[1] coupled with his departure from California at the end of 2020,[2] it is a good time to examine California's complex income sourcing rules for nonresidents, particularly its treatment of equity-based compensation. California's sourcing rules for compensation such as incentive stock options (ISOs), nonqualifying stock options (also known as nonstatutory options) (NSOs), and restricted stock units (RSUs) highlight the long-range reach of California's taxing authority. Further, the decision of the Office of Tax Appeal (OTA) in *Appeal of Prince*[3] provides additional insight on California's ambiguous nonresident sourcing rules for equity-based compensation.

This article will discuss the basic mechanics of California's taxation of nonresidents, specifically related to equity-based compensation. It will analyze Musk's situation — based on publicly available information — as a case study of how the ambiguity in California's sourcing rules can shift hundreds of millions of dollars in tax revenue in and out of the state. Finally, given that the ambiguity will likely lead Musk and countless other taxpayers to battle the Franchise Tax Board on how much, if any, income should be sourced to California, this article will highlight the state's controversy process.

Overview of California Nonresident Taxation

California's personal income tax rules hinge on the threshold question whether the individual taxpayer is a resident or a nonresident of the state. While income from all sources is taxable to California residents,[4] nonresidents are taxed only on income derived from California sources.[5] As income from California sources includes compensation for personal services performed in California, former residents may be taxed on compensation for work they performed while in the state, despite no longer residing there.[6] Often

[1] Tesla, "Statement of Changes in Beneficial Ownership (Form 4)" (Nov. 5, 2021-Dec. 22, 2021).

[2] Heather Somerville, "Elon Musk Moves to Texas, Takes Jab at Silicon Valley," *The Wall Street Journal*, Dec. 8, 2020.

[3] *In the Matter of the Appeal of Prince*, Case No. 19024304 (Cal. Off. Tax App. Jan 1, 2021).

[4] Cal. Rev. & Tax. Code section 17014; Cal. Code Regs. tit. 18, section 17014.

[5] Cal. Rev. & Tax. Code section 17041(i)(1)(B).

[6] Cal. Code Regs. tit. 18, sections 17951-2, 17951-5.

there is ambiguity whether the income is from a California source when individuals receive grants of equity-based compensation — the preferred mode of compensation for many technology companies — at a time when they are California residents but recognize income or gain regarding the compensation after they have ceased to be California residents. Discussed in further detail are the sourcing rules for the three most common types of equity-based compensation.

Incentive Stock Options

ISOs are stock options granted to employees that provide incentives for employees to help grow the company. Neither the grant nor the exercise of an ISO is treated as a taxable event. Instead, income or gain is recognized when the stock is obtained on exercise of the ISO. The sale of ISO stock in a qualifying disposition will result in any gain from the sale being treated as gain from the disposition of intangible personal property sourced solely to the seller's *state of residence* at the time the stock was sold.[7] A qualifying disposition is one that occurs two years or more after the granting of the ISO and one year or more after the exercise of the ISO.[8] If the stock is disposed of in a transaction that is not a qualifying disposition,[9] all or a portion of the gain will be treated as ordinary income rather than gain from the disposition of intangible property.

Nonqualifying Stock Options

NSOs are stock options that do not qualify for the special treatment granted ISOs. Income is recognized at the time of the exercise of an NSO.[10] For nonresidents, the difference between the fair market value of the shares on the exercise date and the value of the shares at the option price is characterized as compensation for services.[11] In this instance, California taxes the income recognized on exercise of the NSO to the extent the taxpayer performed services in California. Thus, a nonresident who received an NSO in exchange for performing services for an employer in and outside California is required to allocate to California the portion of the income recognized on exercise of the NSO reasonably attributed to services performed in California.[12]

While the FTB has not produced a regulation explaining a reasonable allocation method, it has promulgated Publication 1004, which provides a workday allocation method. Under this method, the FTB divides the California workdays from the grant of the NSO to the exercise date by the total workdays during that period. This creates an allocation ratio, which is multiplied by the income generated from the exercise of the option to calculate the California taxable income. The workday method is an *example* of a reasonable method that has been accepted by the Board of Equalization;[13] however, as noted by the OTA, it is not the only method.[14]

Restricted Stock Units

The last form of equity-based compensation is the RSU, which is a stock unit awarded to employees. Unlike an option, an RSU is an award of actual shares. However, it is restricted in the sense that it has a vesting period and is not transferable until it is vested. IRC section 83, to which California conforms,[15] governs an RSU transferred in connection with the performance of services. Gross income for tax purposes includes the gain from an RSU in the first tax year in which "the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier."[16] The rights of a person in property are transferable only if the rights in the property of any transferee are not subject to a substantial risk of forfeiture.[17] Shares that are unvested remain subject to a substantial risk of

[7] California FTB, "Equity-Based Compensation Guidelines," Publication 1004 (revised Jan. 2015).

[8] California conforms under Cal. Code Regs. tit. 18, section 17501.

[9] IRC section 422(a)(1).

[10] *Appeal of Charles W. and Mary D. Perelle*, 1958-SBE-057 (Dec. 17, 1958).

[11] *Id.*

[12] Cal. Code Regs. tit. 18, section 17951-5(b).

[13] *Appeal of Richard R. and Mari J. Cower*, Case No. 294394 (Cal. SBE Sept. 15, 2005).

[14] *Appeal of Prince*, No. 19024304.

[15] Cal. Rev. & Tax. Code section 17081.

[16] IRC section 83(a)(1).

[17] IRC section 83(c)(2).

forfeiture until the vesting dates.[18] Thus, gain is triggered when an RSU has vested.

Like an NSO, an RSU "must be apportioned between this State and other States and foreign countries in such a manner as to allocate to California that portion of the total compensation which is reasonably attributable to personal services performed in this State."[19] Thus, if an employee performs services in California between the grant date and vesting date and becomes a nonresident during that time, a portion of the compensation from the vesting of the RSU is California-source income.

A good illustration of this is seen in the OTA's decision in *Prince*. In *Prince*, the taxpayer was a Facebook employee who began working for Facebook in California in 2007. In 2010 the taxpayer accepted a position with Facebook Singapore. The taxpayer later transferred to Facebook Australia and only visited California for work-related purposes for nine days total after departing in 2010. The taxpayer's compensation included six grants of RSUs that all required the appellant to continue working for Facebook to receive the stock. These RSUs were granted on six dates ranging from 2007 to 2010, and they all vested in the 2012 tax year while the appellant was not a California resident. The OTA determined that the RSUs remained subject to a substantial risk of forfeiture until the vesting dates in 2012.

To allocate a percentage of the vested shares to California, the FTB presented its workday allocation method to the OTA by taking the total number of days worked in California during the vesting period over the number of days in the entire vesting period. In the alternative, the taxpayer provided an allocation formula using an annual stock appreciation method, under which the income attributable to compensation for services in California would equal the value of the stock on the taxpayer's last day of work in California minus the price of the stock on the date of the grant. The taxpayer argued that this method was more reasonable than the FTB's method because the restricted stock "sky-rocketed" in value after the taxpayer left California.

[18] *Appeal of Stabile*, 2020-OTA-198P.

[19] Cal. Code Regs. tit. 18, section 17951-5(b).

The OTA held that, in this instance, the taxpayer's formula was not reasonable, finding insufficient connection between the taxpayer's departure from the state, his services for Facebook, and the increase in stock price. Notably, it wrote, "If evidence existed that showed appellant's personal services had significant impact on the increase in the stock value then it would be possible to link the stock appreciation to appellant's services performed after he became a nonresident of California, but appellant has failed to prove such evidence."[20]

Case Study: Elon Musk

As discussed above, Musk exercised stock options worth over $20 billion. His options were disclosed as NSOs granted on August 13, 2012,[21] and as of December 23, 2021, he exercised 21,307,874 stock options with an exercise price of $6.24 per share.[22] For ease of the calculation, we will assume all the options were exercised on the same day, December 2, 2021,[23] and the market value of the shares was $1,027.21.[24] Further, we will assume Musk was no longer a California resident after December 9, 2020.

After taking the assumptions into consideration, California will require Musk to allocate a portion of the total compensation that is reasonably attributable to personal services performed in California. The total compensation is the difference in value of the shares at the market price on the day of exercise and the exercise price. In this instance, the FTB will likely argue the workday allocation method by citing Publication 1004. Using this method, Musk spent 2,072 business days in California out of 2,306 total business days.[25] Thus, 89.85 percent of the gain would be allocated to California. Musk's compensation is $21,754,615,717 (21,307,874

[20] *Appeal of Prince*, OTA No. 19024304.

[21] Tesla, *supra* note 1.

[22] *Id.*

[23] Between November 8, 2021, and December 2, 2021, Musk had exercised 10,662,127 stock options. Tesla, *supra* note 1.

[24] This estimate was reached by taking the average closing price of the exercised options, weighted by number of shares exercised. Tesla, *supra* note 1.

[25] California working days from August 13, 2012, to December 9, 2020. Total working days are August 13, 2012, to December 2, 2021. Both exclude weekends and public holidays.

shares * $1,027.21 - $6.24 * 21,307,874 shares). Using the 89.85 percent workday allocation percentage, $19,547,078,823 of the gain would be sourced to California, which, multiplied by the top California individual tax rate (12.3 percent), would result in a tax bill of $2,404,290,695.

Unlike the taxpayer in *Prince*, Musk may have a stronger argument to use the appreciation method because the increase in the Tesla stock price may arguably be tied to his actions as Tesla CEO. In *Prince*, the OTA suggested that if evidence showing the taxpayer's "personal services had significant impact on the increase in the stock value then it would be possible to link the stock appreciation to appellant's services performed after he became a nonresident of California."[26]

Using the appreciation method, the value of a share of Tesla stock on December 9, 2020, was $654.[27] Thus, the value attributable to California under this method would be $13,802,388,462 (21,307,874 shares * $654 - 21,307,874 shares * $6.24), which, multiplied by the top California individual tax rate, results in a tax bill of $1,697,693,780. Thus, the estimated difference between the two calculations is over $700 million.

Given the roughly $700 million dollar tax difference between the California tax liability under the two methods, the FTB will likely dig in its heels and apply the workday method. Assuming Musk fights the FTB's use of this method, he will have to endure the long and arduous tax controversy process in California. First, he will go through an audit that will last multiple years and require him to respond to many information document requests. Presumably the auditor will disagree with Musk's argument to use the appreciation method and issue a notice of proposed assessment. Musk will then need to file a protest of the notice with the FTB. The protest process will likely require him to respond to more IDRs and eventually conduct a protest hearing. Like the FTB auditor, the FTB protest officer will likely deny Musk's protest, which will then require him to appeal to the OTA and go through California's quasi tax court with briefing and an oral hearing. All of this is to say that the process is long, and many substantial matters can take over eight years to resolve at this level. Assuming the FTB assessment interest rate of 3 percent, assessment interest over eight years could tack on another $188,498,916 to Musk's tax bill. Then, should the FTB prevail at OTA, he would have to "pay to play" to continue the fight in the California court system.

Conclusion

The pandemic has decentralized the technology industry from its power center in California to all over the world. With technology employees working remotely, many highly compensated technology executives have followed suit and have moved out of California to lower tax jurisdictions. While terminating California residency is an uphill battle, it continues for many of these employees and executives that received equity-based compensation while working in California. As illustrated by our case study, how a nonresident reasonably allocates income to California could be a difference of billions of dollars in revenue for the Golden State. ■

[26] *Appeal of Prince*, OTA No. 19024304.

[27] The high for Tesla stock for December 9, 2020, was $654 per share.